Internal Revenue Service

memorandum

CC:TL-N-10056-87
Br2:PLBurquest-Fultz

date: OCT 30 1987

to: District Counsel, Cleveland C:CLE

from: Acting Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your request for technical advice of May 27, 1987.

ISSUE

Whether [redacted] ([redacted]), succeeded to the tax attributes of [redacted]. RIRA Nos 0351.00-00; 0381.00-00; 0382.00-00; 0269.00.

CONCLUSIONS

1) [redacted] carries on the same tax identity as [redacted], because it operates under [redacted]'s corporate charter after certain amendments including, a name change to [redacted] and the issuance of additional common and preferred shares.

2) In the absence of the application of the Libson Shops doctrine, I.R.C. § 382(a), or § 269, [redacted] will succeed to the net operating loss carryovers of [redacted].

3) Service position would support application of the Libson Shops doctrine to the facts presented to deny carryover of net operating losses to [redacted]. However, there are hazards in litigating the issue as a result of the Sixth Circuit's reliance on Maxwell Hardware Company v. Commissioner in deciding a loss carryover case under the 1954 Code. If [redacted] begins to use the NOL carryovers of [redacted], the facts surrounding that utilization should be reviewed to determine whether our position on the application of the Libson Shops doctrine has been strengthened or weakened by those facts.

FACTS

In addition to the facts presented in the August 21, 1987, technical advice memorandum on three additional issues, the following facts are provided:

The last federal income tax return filed by [redacted] relates to the [redacted] taxable year. This return indicates that the affiliated group, which consists of [redacted] and all of its U.S. subsidiaries, has net operating loss (NOL) carryovers available for use in tax years ending after [redacted], which, unless utilized, will expire as follows (in millions):

Year of Expiration	Amount of NOL Carryover
[redacted]	$ [redacted]
	$ [redacted]

In addition to the above loss carryovers, [redacted]'s books and records at [redacted], reflect approximately $[redacted] of net liabilities for which deductions have not been accruable on tax returns. It is possible that tax deductions in that amount may be accrued and reflected on future tax returns.

Pursuant to the [redacted] reorganization plan, all pre-bankruptcy businesses operated by the consolidated group (with the exception of the [redacted] manufacturing business) were sold via asset or stock sales. Most of the sales proceeds were placed in the hands of the Disposition Asset Trustee (DAT) for distribution to creditors.

Under the reorganization plan, creditors were divided into [redacted] classes. Cash distributions were made to Class [redacted], Class [redacted], and Class [redacted] allowed claims. "Reorganization securities" were distributed to Class [redacted], Class [redacted], and Class [redacted] allowed claims; in addition, some amounts of available cash were distributed to these creditors. Class [redacted] allowed claims were held by pre-reorganization shareholders of [redacted] and the holders of options and warrants of [redacted] stock. The shares of [redacted] owned by Class [redacted] members were converted into [redacted] of a share of [redacted] common stock for each pre-reorganization share held. Options and warrants in [redacted] were cancelled if unexercised on the date the plan of reorganization was confirmed.

The reorganization securities, referred to above, consisted of newly issued, common and preferred shares of [redacted]. Creditors receiving common and preferred stock in exchange for allowed claims owned approximately [redacted] percent of the outstanding common shares upon confirmation of the plan and completion of the stock purchase agreement, discussed later. Preferred shares received by the creditors represent approximately [redacted] percent in voting power and approximately [redacted] percent in value of outstanding preferred shares after confirmation of the plan and completion of the stock purchase agreement. For this purpose, value has been determined based on the stated future redemption price under the reorganization plan and may not reflect actual future value, based on differing redemption dates for each class of preferred stock.

The plan contemplated the sale of approximately [redacted] percent of [redacted] common stock to [redacted] ([redacted]). [redacted] is a Delaware corporation, unrelated to [redacted] or its pre-reorganization shareholders. In addition to [redacted] stock, [redacted] purchased [redacted] percent of the outstanding stock of [redacted], [redacted]'s sole surviving subsidiary. [redacted] also purchased options in [redacted], exercisable during [redacted], [redacted], and [redacted]. The exercise of these options would give [redacted] over [redacted] percent of the outstanding stock of [redacted].

The plan provided for the name change of [redacted] to [redacted]. The corporate articles of [redacted] were amended to expressly state that [redacted] will have no other businesses or direct subsidiaries (other than those currently conducted or owned), and that all future businesses in which it may engage shall be conducted by or through [redacted] or subsidiaries of [redacted].

DISCUSSION

APPLICABILITY OF THE LIBSON SHOPS DOCTRINE TO DENY CARRYOVERS

Before the enactment in 1954 of I.R.C. § 381 of the 1954 Code, there was no statutory authority to permit the carryover of NOLs to a successor or acquiring corporation of the corporation that realized the losses. Judicial authority restricted the use of NOLs to the taxable entity that

produced the loss,1/ unless the acquisition took the form of a statutory merger. However, the Supreme Court's decision in Libson Shops v. Koehler, 353 U.S. 382 (1957), restricted carryover of NOLs in mergers to those situations where the pre-merger losses of one business would be used to offset only the post-merger income of the same business.

After the enactment of § 381, the Service announced that it would not rely upon the principle from Libson Shops that pre-merger NOLs of one business could not offset post-merger income of another business where the transaction was described in § 381(a) of the 1954 Code. Rev. Rul. 58-603, 1958-2 C.B. 147, and Rev. Rul. 59-395, 1959-2 C.B. 475. This raised the issue of whether carryovers would be denied under Libson Shops where the transaction was outside of the scope of §381.

The initial IRS position regarding the continued viability of the Libson Shops doctrine to situations outside the scope of § 381 was announced in Rev. Rul. 63-40, 1963-1 C.B. 46, G.C.M. 32507, I-817, (Feb. 8, 1963), later modified by T.I.R. 773. The ruling states:

> In cases . . . in which losses have been incurred by a single corporation and there has been little or no change in the stock ownership of the corporation during or after the period in which the losses were incurred, the Internal Revenue Service will not rely on the rationale of the Libson Shops decision to bar the corporation from using losses previously incurred solely because such losses are attributable to a discontinued corporate activity.

T.I.R. 773 modified the above statement to restrict reliance on Libson Shops to those situations not covered by § 381(a), where there has been both a 50 percent or more shift in ownership and a change of business, as defined in § 382(a) and the regulations thereunder.

1/ Woolford Realty Co. v. Rose, 286 U.S. 319 (1932); New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934).

Under the facts presented, there has been a change of at least 50 percent of the pre-bankruptcy stock ownership of [redacted]. This change formally occurred as of the date the bankruptcy reorganization plan was confirmed by the Bankruptcy Court on [redacted]. However, the creditors' equity interest in the corporation was, in substance, acquired when the bankruptcy proceedings commenced. In Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942), the Supreme Court stated:

> When the equity owners are excluded and the old creditors become the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority. At that time they stepped into the shoes of the old stockholders.

Under the facts presented in the [redacted] reorganization plan, creditors committees were appointed beginning in [redacted], shortly after commencement of the reorganization proceedings. The committees have participated actively in the negotiation and preparation of the plan. Accordingly, based on the rationale in Alabama Asphaltic, we conclude that the change of ownership occurred in [redacted].

Creditors exchanged allowed claims with an aggregate value of approximately $[redacted] for stock claims under the reorganization plan. These claims were impaired under the plan, resulting in a forgiveness of indebtedness of approximately $[redacted]. This forgiveness indicates that the fair market value of the [redacted] assets was less than the dollar amount of the outstanding claims and supports the position that the change of ownership was in excess of 50 percent.

Within two years from the date the plan of reorganization was adopted by [redacted], a substantial portion of its assets had been sold. Specifically, the following dispositions had occurred.

1) The U.S. [redacted] business owned by [redacted] (a wholly owned subsidiary of [redacted]) was sold in [redacted], via a stock sale to [redacted], a subsidiary of [redacted]

[redacted]. (Note: [redacted] continued to exist and filed a separate plan of reorganization after the purchaser defaulted on the debt to [redacted].)

2) The Canadian [redacted] division of [redacted] (a wholly owned subsidiary of [redacted]) was sold on [redacted], to a joint venture corporation, comprised of [redacted] and [redacted]. [redacted] later acquired [redacted]'s interest.

3) The Canadian [redacted] division of [redacted] was sold on [redacted], to a corporation owned jointly by [redacted] and [redacted].

4) All shares of [redacted] (a wholly owned foreign subsidiary) were sold to [redacted] on [redacted]. [redacted] is an affiliate of a former [redacted] distributor.

5) [redacted]'s U.S. [redacted] business (other than the [redacted] manufacturing assets) was sold to [redacted], a subsidiary of [redacted]. The sale closed on [redacted].

6) The former corporate office and research facility in [redacted], [redacted], was sold to a subsidiary of [redacted] on [redacted].

7) Stock of [redacted] (a wholly owned subsidiary of [redacted]) was sold to [redacted] on [redacted]. Prior to the sale, [redacted] (a wholly owned subsidiary of [redacted]) was transferred to [redacted].

8) [redacted] was liquidated into [redacted] shortly after [redacted].

9) Certain [redacted] assets were sold in connection with the sale of the Canadian [redacted] business to the joint venture corporation described in 3) above, on [redacted].

After the various sales transactions were completed, [redacted]'s assets consisted of: 1) the capital stock of [redacted]; 2) the [redacted] manufacturing assets (consisting of machinery, equipment, tooling, inventory, accounts receivable, contract rights, intangible property, and other

assets); 3) operating assets, consisting of approximately $[redacted]; and 4) approximately [redacted], formerly used in its [redacted] business. The land was sold [redacted].

The reorganization plan provided that the emerging corporation, [redacted], would continue to carry on the [redacted] manufacturing business formerly operated as a division of [redacted]. However, the asset and stock sales described above have resulted in a discontinuance of all businesses of the subsidiaries as well as [redacted]'s [redacted] manufacturing business. The notes to the financial statements included with [redacted]'s Annual Report on Form 10-K for the year ended [redacted], state that the [redacted] assets were not in service during that year, thereby indicating a total cessation of business, albeit temporary.

Pursuant to the Service's announcement in T.I.R. 773, the regulations under § 382 will be applied to determine whether a change in the corporation's business has occurred.

Treas. Reg. § 1.382(a)-1(h)(1) provides that the change in trade or business may occur at any time on or after the date the increase in stock ownership occurs.

Treas. Reg. § 1.382(a)-1(h)(7) states that if a corporation discontinues more than a minor portion of its business carried on before the increase in ownership, it will not be considered to continue to carry on a trade or business substantially the same as that conducted before the increase in ownership.

Based on the substantial asset and stock sales that have occurred since [redacted], when the creditors effectively assumed equity ownership of [redacted], we conclude that [redacted] ([redacted]) has not continued to carry on a trade or business substantially the same as that conducted before the stock ownership increase occurred. Therefore, Service position would support applying Libson Shops to deny the use of net operating loss carryovers from [redacted] to offset subsequent income of [redacted], except possibly for the income generated by the [redacted] manufacturing business. Since it appears that the [redacted] business is not generating much income, it would seem that very little of the NOLs would be used unless [redacted] acquires a new, large income-producing business.

The survival of the Libson Shops doctrine after the 1954 Code, while unsettled in the Sixth Circuit Court of Appeals, would appear very doubtful and fraught with litigating hazards. In Frederick Steel Company v. Commissioner, 375 F.2d 371 (6th Cir. 1967), cert. denied, 389 U.S. 901 (1967), the Ninth Circuit's opinion in Maxwell Hardware Company v. Commissioner, 343 F.2d 713 (9th Cir. 1965) (saying that the Libson Shops doctrine did not survive after the 1954 Code) was followed by the Sixth Circuit when it permitted pre-acquisition losses of one corporation to offset post-acquisition income of another corporation. Although the Court in Frederick Steel did not specifically state that Libson Shops had no application after the 1954 Code, the result is consistent with Maxwell Hardware. In a later decision, the Sixth Circuit stated that Libson Shops' decisional authority "may have been superceded by the 1954 amendments to the Internal Revenue Code," thereby indicating that it has not made a final conclusion that Libson Shops is dead. Six Seam Company, Inc. v. U.S., 524 F.2d 347 (6th Cir. 1975).

We have analyzed the case law following Libson Shops under the 1954 Code. The prospects for success on its application appear doubtful in many circuits. We have assumed the case would be tried in the Sixth Circuit or using Sixth Circuit precedent in the Tax Court under application of the Golsen 2/ rule. Under Frederick Steel and Six Seam, it is very likely that the Sixth Circuit would hold Libson Shops to be superceded in cases governed by the 1954 Code.

The Conference Committee explanation of the amendments to § 382 by the Tax Reform Act of 1986 can be argued to give rise to an implication that the Libson Shops doctrine applies to years governed by the 1954 Code prior to 1986. 3/

2/. Jack E. Golsen, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971), cert den'd, 404 U.S. 940 (1971).

3/. The Conference Report states that the conferees intend that the Libson Shops doctrine will have no application to transactions subject to the provisions of the conference agreement. See H.R. Rep. No. 841, 99th Cong., 2d Sess. 194 (1986). By negative inference, this statement can be argued to imply that the Libson Shops doctrine is applicable to transactions outside of the scope of "new" § 382, such as the [redacted] reorganization.

However, both the House and Senate committee reports indicate some uncertainty as to its application after the enactment of the 1954 Code. 4/ Although this discussion of "uncertainty" is not included in the Conference Committee report, the House and Senate reports may limit the pro-Libson Shops implication which could be drawn from the Conference Committee report. Furthermore, the Supreme Court has held that "the views of one Congress as to the construction of a statute adopted many years before by another Congress have 'very little, if any significance.'" United States v. Southwestern Cable Company, 392 U.S. 157, 170 (1968) and Rainwater v. United States, 356 U.S. 590 (1958). This statement was used by the Tax Court in a recent case to support its refusal to recognize later expressions of Congressional intent to overrule a prior case decided under Code provisions enacted by a previous Congress. Mars, Incorporated and Uncle Ben's Inc. v. Commissioner, 88 T.C. No. 19 (February 11, 1987).

In summary, there would be great litigating hazards in attempting to apply Libson Shops in this case, although Service position would support doing so. Since it is unclear how and when these NOLs will be used, we recommend that you seek further advice when the NOLs are used.

4/. These reports contain the following statement:

> There is uncertainty whether the Libson Shops doctrine has continuing application as a separate nonstatutory test under the 1954 Code. Compare Maxwell Hardware Co. v. Commissioner, 343 F.2d 713 (9th Cir. 1965) (holding that Libson Shops is inapplicable to years governed by the 1954 Code) with Rev. Rul. 63-40, 1963-1 C.B. 46, as modified by T.I.R. 773 (October 13, 1965), (indicating that Libson Shops may have continuing vitality where, inter alia, there is a shift in the "benefits" of an NOL carryover).

H.R. Rep. No. 426, 99th Cong., 2d Sess. 253 (1986) and S. Rep. No. 313, 99th Cong., 2d Sess. 228 (1986).

THE APPLICABILITY OF SECTION 269 TO DENY THE USE OF NET OPERATING LOSS CARRYOVERS

The Service will use § 269 in appropriate situations where "control" of a corporation is acquired and the principal purpose for the acquisition was the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which the acquirer would not otherwise obtain. The term "control" is defined in § 269 to mean ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of all classes of stock.

We do not believe that the acquisition of an equity interest in [redacted] by its creditors (under Alabama Asphaltic's rationale, by the commencement of the reorganization proceedings) is an acquisition having as its principal purpose the avoidance of Federal income tax under § 269 by securing the benefit of net operating loss deductions of [redacted]. Generally, creditors are able to demonstrate motives other than tax avoidance for acquiring an equity interest in a corporation. The [redacted] reorganization allowed creditors to participate in the business decisions of the company, and perhaps, turn the company profitable in future years, thereby increasing the potential of a greater recovery on their earlier loans to [redacted]. Tax avoidance appears to have played a minor role, if any role at all, in this equity acquisition.

However, future acquisitions by [redacted] (via [redacted]) of profitable businesses, unrelated to the [redacted] manufacturing business, may present a situation where sufficient tax avoidance purposes exist to justify the disallowance of the use of [redacted]'s NOL carryovers. (See Vulcan Materials Company v. U.S., 446 F.2d 690 (5th Cir. 1971), aff'g 308 F. Supp. 53 (N.D. Ala. 1969) and Briarcliff Candy Corporation and Subsidiaries v. Commissioner, T.C.M. 1987-487.) We advise you of the potential future application of § 269 so that you may consider its applicability if facts develop which indicate a tax avoidance purpose for any later acquisition of profitable businesses.

DISCUSSION OF OTHER RELATED AREAS

In determining whether [redacted] could utilize the losses of [redacted], we also looked at whether the Willingham doctrine could be used to deny the carryover of NOLs from [redacted], or whether

§ 382 would apply to eliminate any [redacted] carryover obtained by [redacted]. These topics are discussed briefly below.

APPLICATION OF WILLINGHAM

Prior to the Internal Revenue Code of 1954, several court decisions limited the use of NOL carryovers by successor corporations resulting from corporate reorganizations within or without bankruptcy proceedings. In New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934), the Supreme Court held that loss carryovers could only be used by the corporate entity that sustained the loss; consequently, loss carryovers died with the terminated corporate entity.

In a case decided under the 1939 Code,the Fifth Circuit held that a corporation emerging from bankruptcy was not the same corporation that sustained the pre-bankruptcy losses (even though it maintained the same tax identity during and after the bankruptcy proceedings), because it was a "new business enterprise." Willingham v. U.S., 289 F.2d 283 (5th Cir. 1961), cert denied, 368 U.S. 828 (1982). With the enactment of 1954 Code came § 381, which allowed carryovers to specified types of reorganizations. No mention was made of bankruptcy reorganizations.

The Service litigated the continued viability of Willingham in bankruptcy reorganizations after the 1954 Code in Jacqueline, Inc. v. Commissioner, T.C.M. 1977-340, and Daytona Beach Kennel Club, Inc. v. Commissioner, 69 T.C. 1015 (1978). The Tax Court refused to apply the Willingham rationale where the bankruptcy reorganization plan was one of the types enumerated in § 381(a). In [redacted], O.M. 18989, I-588-74 (Aug. 31, 1978), the Interpretative Division recommended that Jacqueline and Daytona Beach be appealed. However, O.M. 18989 was later revoked by [redacted], G.C.M. 37966, I-77-79 (May 25, 1979), in light of the decision by the Justice Department and the Tax Litigation Division not to appeal the cases. [redacted], O.M. 19085, I-77-79 (April 12, 1979) also indicates that although reliance on Willingham may be justified, the position would not be maintained, based on the apparent position not to defend it in litigation.

As a result, the Service has permitted the corporation emerging from bankruptcy proceedings to carryover pre-

bankruptcy losses to offset post-bankruptcy income. This is contrary to the rule stated in Willingham.

The [redacted] reorganization plan provides for the continued existence of [redacted] as a tax entity, under the name of [redacted]. § 381 is not necessary to activate the carryover of NOLs. Even though the facts of the [redacted] reorganization come within the scope of Willingham, the current position enunciated in G.C.M. 37966 prohibits its use to deny these carryovers.

APPLICATION OF SECTION 382(A)

Corporate ownership changes occurring on or before December 31, 1986 are subject to the provisions of "old" § 382 which came into the Code in 1954. Although the Tax Reform Act of 1976 amended this old version of § 382, the effective date of those amendments was postponed by later tax acts, and finally the amendments were retroactively repealed by the Tax Reform Act of 1986. Under the 1986 act, the "old" provisions of § 382 were reinstated for ownership changes occurring on or before December 31, 1986, and a new set of rules was provided for ownership changes occurring after December 31, 1986.

Under "old" § 382, net operating loss carryovers of a corporation emerging from bankruptcy can be eliminated if any one or more of the corporation's 10 largest shareholders 5/ have increased their stock ownership by 50 percent or more as a result of a stock "purchase" and the corporation does not continue the historic business engaged in prior to the change of ownership. This version of § 382 would be applicable to the [redacted] reorganization, if the purchase and change of business requirements are met.

The term "purchase", as defined in § 382(a)(4), requires a stock acquisition in which the basis of the stock is determined solely by reference to its cost to the shareholder in a transaction from a person other than one whose stock would be attributed to the shareholder under the attribution of ownership rules of § 382(b)(5).

5/. The ten largest shareholders referred to are the ten persons who at the end of the year in which a change in ownership occurs own the greatest percentage of the fair market value of the outstanding stock of the corporation. See "old" § 382(a)(4).

We have concluded previously that under the rationale of Alabama Asphaltic, the creditors will be considered to have received an equity interest in [redacted] at the time creditors committees were appointed under the Bankruptcy Code, in [redacted]. The conversion of a creditor interest into an equity interest in [redacted] will not be treated as a "purchase" under § 382(a)(4), because the stock received takes a carryover basis under § 358 equal to the basis of the debt exchanged, rather than a cost basis. This is because the creditors effectively got more than [redacted] percent of the equity of [redacted] at the time the creditors committees were formed in [redacted] and this stock acquisition would qualify as a tax-free transaction under § 351. See Alabama Asphaltic, supra. Even if the creditors had received their equity interest at the time of confirmation of the reorganization plan in [redacted], [redacted] was another transferor so that the transferors as a group (i.e., the former creditors and [redacted]) obtained [redacted] percent control of [redacted].

We have also concluded previously that the change of trade or business requirement has been met. However, because the facts surrounding the creditors' acquisition of their equity interest in [redacted] was not considered a "purchase," we must conclude that § 382 is not applicable to deny the carryover of [redacted]'s NOLs to [redacted].

CONCLUSION

Based on the above discussion, we have concluded that [redacted] and [redacted] share the same tax identity. As such, [redacted] can use [redacted]'s NOL carryovers, unless they are limited by statutory provisions or judicial doctrines.

The facts of the [redacted] reorganization indicate that [redacted] underwent approximately a [redacted] percent change of ownership and that most of the pre-bankruptcy businesses of [redacted] and its subsidiaries were sold via either stock or asset sales. Under these facts, Service position supports applying the Libson Shops doctrine to eliminate NOL carryovers associated with the businesses disposed of. That is, under an application of Libson Shops, the NOLs could only be used to offset the income generated by the [redacted] manufacturing business.

There are compelling reasons to apply Libson Shops to the [redacted] reorganization. Specifically, the reorganization

plan operated as a liquidation of most of [redacted]s businesses, with most of the sales proceeds going to creditors. Additionally, on the asset sales to unrelated third parties, [redacted] most likely would have had smaller gains than should be equitably allowed where the asset bases reflected debt that was not required to be repaid by [redacted] and that was extinguished in the bankruptcy reorganization. Nevertheless, there are substantial risks in litigating the issue in this case in the Sixth Circuit (and in the Tax Court, which under the Golsen rule would follow the Sixth Circuit), as a result of the Sixth Circuit's acceptance of Maxwell Hardware in Frederick Steel and its view of Libson Shops as expressed in Six Seam.

Section 269 could possible apply to eliminate use of the carryovers in the future, if the acquisition of a profitable business by [redacted] occurs and the principal purpose of the acquisition is the avoidance of tax via the use of the NOLs. We are prepared to assist you in this regard, as facts develop.

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by: _____
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